THE CITY OF SAN DIEGO

# REPORT TO THE CITY COUNCIL

DATE ISSUED: December 18, 2006 REPORT NO:

ATTENTION: Council President and Members of the City Council, City Council Meeting of January 8, 2007

SUBJECT: Proposition 218 Noticing of Proposed Sewer Rate Adjustments

REFERENCE:

REQUESTED ACTION:

- Council authorization to notice, pursuant to Proposition 218 to include the following:
  - Proposed sewer rate adjustments, increasing sewer system revenues by 8.75% in Fiscal Years 2007 and 2008 and 7% in Fiscal Years 2009 and 2010
  - Shames' Lawsuit settlement impact to Sewer Service Charges of 3.05% in Fiscal Years 2007 and 2008, 0.6% in Fiscal Year 2009, and 0.5% in Fiscal Year 2010, assuming the above rate increases are also implemented
  - Raise Single Family Residential (SFR) billing cap from 14 Hundred Cubic Feet (HCF) to 20 HCF
  - Reduce return to sewer ("return") factor for SFR water usage from 100% to 95%
  - New SFR customer rate increase from $35.88 to $38.32; and
- Set the public hearing date to consider proposed rate adjustments at the City of San Diego Council Mmeeting of February 26, 2007; and
- Receive the Wastewater Cost of Service Rate Study as the basis for establishing the rate structure.

STAFF RECOMMENDATION:

- Authorize the Mayor or his designee to initiate Proposition 218 noticing for the sewer rate adjustments by 8.75% on May 1, 2007 and May 1, 2008 (Fiscal Years 2007 and 2008), 7.00% on May 1, 2009 and May 1, 2010 (Fiscal Years 2009 and 2010) to ensure continued compliance with federal and state mandates and allow MWWD to enter into a Final Consent Decree with the United States Environmental Protection Agency (EPA) by June 30, 2007.
- Set the public hearing date to consider proposed wastewater rate adjustmetns at City of San Diego Council Meeting of February 26, 2007; and
- Receive the Wastewater Cost of Service Rate Study .

RAMIFICATIONS OF NO RATE INCREASES:

The proposed rate increases are on a critical timeline that is driven by litigation over past sewer spills in the consolidated cases of *United States v. City of San Diego* (Case No. 03-CV-1349K) and *Baykeeper v. City of San Diego* (Case No. 01-CV-0550B). The City is currently operating under a Partial Consent Decree entered in these cases, which expires on June 30, 2007. If the City has not obtained the funding necessary to approve and lodge a Final Consent Decree with the Court by June 30, 2007, it is likely the stay of litigation will be lifted and the cases will proceed to trial. This would result in rate payer-generated revenues being applied to litigation costs in addition to court-mandated improvements to the infrastructure. In addition, MWWD will be unable to access public or private financing, resulting in significant delays or suspension of infrastructure projects. Delays in these critical infrastructure projects will put the system at risk of collection and treatment system failures, increased sewage spills, violation of regulatory permits, and potential fines or other enforcement actions from regulatory agencies.

In order to approve and lodge a Final Consent Decree by June 30, 2007 and avoid the potential problems described above, the following timeline is imperative:

- January 8, 2007 - City Council hearing to set the public hearing as required by Proposition 218
- January 11, 2007 - Proposition 218 notice must be mailed to meet the 45 day noticing requirement
- February 26, 2007 - City Council public hearing to consider proposed rate increases (45 days after mailing the Proposition 218 notices) and introduction of ordinance authorizing a bond issuance and financing documents. The bond financing is anticipated to be a private financing.
- April 2007 – Closing of the bonds, and bond funds available for the Wastewater System and City Council consideration of a Final Consent Decree
- May 1, 2007 - rate increase effective to support the bond issuance and signing of the Final Consent Decree
- June 30, 2007 - deadline to lodge Final Consent Decree

This timeline and each of its dates for specific action is critical to ensure that MWWD complies with the EPA mandates. The Court has allowed MWWD to postpone the signing of the Final Consent Decree due to the City's financial crisis. However, the Court has firmly indicated that it will not allow further postponement of signing the Final Consent Decree.

The Raftelis Financial Consultants, Inc. Cost of Service Study's (COSS) recommendations are consistent with and are reflected in the wastewater basis for the sewer rate base fee and HCF fees being proposed. The City Council's ability to deviate from these rates is limited: the rate adjustments proposed by this report can only be changed if the alterations are consistent with the COSS. Changes that are inconsistent with the COSS could violate the requirement of Proposition 218 and State guidelines that sewer fees not exceed the proportionate cost of providing the service to each parcel. Therefore, any proposed changes should be examined carefully.

SUMMARY:

**Background**

Under the Final Consent Decree, the City is required to replace or rehabilitate pipelines and trunk sewers, upgrade various pump stations, and maintain the Operations & Maintenance (O&M) system at current levels. The Capital Improvement Program (CIP) is intended to address these issues as well as ensure sufficient O&M activities. In order to support this CIP, additional funds will be required through a

combination of bonds, grants, state revolving fund loans and cash. This investment in infrastructure will require a series of rate increases beginning May 1, 2007. Pursuant to Proposition 218, and prior to Council's formal consideration of rate increases, the City must provide property owners 45 days advance notice when any rate increases will be considered. This action authorizes this Notice to take place.

**Proposition 218**

On November 5, 1996, the voters of the State of California approved Proposition 218, the "Right to Vote on Taxes Act." Proposition 218, effective July 1, 1997, added Articles XIIIC and XIIID to the State Constitution, which contain a number of provisions affecting the ability of local governments to levy and collect both existing and future taxes, assessments, fees and charges. Article XIIID, section 6(a)(1) imposes noticing procedures for imposing a new or increasing an existing property-related fee or charge. This initiative changed the way the public is notified of proposed fee increases. Specifically, it requires that notices be mailed to all property owners of record at least 45 days in advance of the date on which a proposed property related fee increase may be adopted.

Therefore, it is the intent of MWWD to mail notices on or before January 11, 2007, to property owners of record and City of San Diego sewer bill customers, advising them that the City Council of the City of San Diego will hold a public hearing on February 26, 2007 to consider adoption of the proposed revisions to existing sewer fees and charges. If adopted, the revisions would become effective on May 1, 2007 and annually thereafter through May 1, 2010.

**History**

In June, 1990, City Council approved a 6% increase in sewer service charges for five consecutive years, Fiscal Years 1991 through 1995. At that time the City Council also approved a 16% increase in sewer capacity charges. In January, 1999, Council again approved increasing all sewer service charges by 5% for three consecutive years, Fiscal Years 1999 through 2001. The emphasis of these increases was on the maintenance, repair, upgrade and expansion of the Metropolitan System in order to ensure compliance with the Ocean Pollution Reduction Act (OPRA) and the Stipulated Order in *United States v. City of San Diego* (Case No. 88-1101-B). The Stipulated Order required specified upgrades of the sewer collection system, including the replacement of 60 miles of concrete mains by June 30, 2003, a comprehensive pump station and force main audit, an upgraded information system, additional grease control, and incorporation of the capital improvement projects listed in the Interim Order.

Major accomplishments during this timeframe include the completion of the North City Water Reclamation Plant, South Bay Water Reclamation Plant, Metropolitan Biosolids Center, South Bay Ocean Outfall, Wastewater Operations Management Network, and major upgrades to the interceptor system and the Point Loma Wastewater Treatment Plant. As MWWD approached the completion of the major upgrades to the Metropolitan System, the emphasis shifted to the Municipal System, which consists of nearly 3,000 miles of pipeline and 80 pump stations.

In October, 2001, City Council approved increasing all sewer service charges by 7.5% for four consecutive years, Fiscal Years 2002 through 2005, to ensure continued compliance with the requirements of the Clean Water Act, OPRA, the State Ocean Plan, the National Pollutant Discharge Elimination System Permit, and the Stipulated Order (City Manager's Report No. 01-209). A portion of these increases was required to fund an Administrative Order from the EPA to reduce sewer spills. The following are the rate increases that were considered in October, 2001 of which the first four where approved and implemented:

| FY02 | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 |
|---|---|---|---|---|---|---|---|---|
| 7.5% | 7.5% | 7.5% | 7.5% | 6.5% | 5.0% | 5.0% | 5.0% | 5.0% |

The proposed program included increasing the rehabilitation and replacement of the deteriorated pipelines from the current 15 to 20 miles to 60 miles per year. Subsequently an extensive closed circuit televising condition assessment of over one third of the pipeline system led to the recommendation that the pipeline rehabilitation and replacement program only be increased to 45 miles per year. This assessment determined that certain areas of the pipeline system were in satisfactory condition, resulting in a revised life expectancy that exceeded preliminary estimates.

Additionally, as the program was implemented, it was determined that only half of the nearly 3,000 mile pipeline system was being cleaned on a regular basis. Therefore, the City Council approved a staff recommendation to increase Wastewater Collection Division personnel and equipment assigned to pipeline maintenance. The additional maintenance resulted in the entire system being cleaned on a regular, scheduled basis, resulting in an 81% reduction in the number of sewage spills through Fiscal Year 2006.

Despite reducing the Municipal Capital Program from the projected 60 miles per year to 45 miles per year, construction cost increases substantially exceeded inflation-based cost projections. In 2004, MWWD received a $152 million loan from Bank of America, which allowed the department to continue working on the Administrative Order, enabling completion of 30 miles of pipe replacement and rehabilitation per year. Because MWWD did not receive the proposed Fiscal Year 2006 rate increase, the CIP program has been substantially reduced in order to stay within current revenues.

City staff is currently working on a private financing option expected to be executed in April, 2007 to retire the outstanding loan obligation with Bank of America and fund the first year of capital projects required by the proposed Final Consent Decree in the consolidated cases of *United States v. City of San Diego* (Case No. 03-CV-1349K) and *Baykeeper v. City of San Diego* (Case No. 01-CV-0550B) in order to continue rehabilitation and replacement efforts. The next bond offering required to meet the Fiscal Years 2008 and 2009 capital needs is expected to occur in April, 2008. To ensure accurate estimates, an external consultant has conducted an analysis of the projected costs. Since the 2001 rate case anticipated needs through 2010 and construction costs have increased substantially over the 2001 assumptions, it is expected that additional rate increases will be needed to continue the system replacement and upgrade efforts beyond the current rate proposal.

**Current Need**

The City owns and operates a regional wastewater system that includes both the Municipal (Muni) and Metropolitan (Metro) Systems. The Muni system is a sewage collection system of nearly 3,000 miles of pipe that serves the City's service area. The Metro system, which services both the City and Participating Agencies (PAs), includes facilities which provide advanced primary treatment, secondary treatment, tertiary reclamation, sludge processing and effluent disposal. The Metro System currently includes three wastewater treatment plants that are operational, two ocean outfalls, a biosolids processing center, three major pump stations, and several miles of force mains and gravity flow interceptors. Due to the complex exchange of effluents, solids and centrates, sharing of one common outfall and receipt of flows from the participating agencies, the Metro system is viewed and operated as "a regional system" from a permitting, regulatory compliance and operational efficiency standpoint.

MWWD focused on the needs of the Muni system in the early 2000s and there continues to be a critical need to rehabilitate or replace many pipelines, trunk sewers and pump stations through 2013. The following is the list of needs contemplated in the rate case and in compliance with the proposed sewer spills consent decree:

- Replacement and rehabilitation of 250 miles of sewer pipeline, including 17 specific trunk sewers
- Upgrade of 12 sewer pump stations

- Replace aging infrastructure, estimated at $648 million, including specific projects required by the proposed Final Consent Decree: (see Attachment)
    - $277 million for pipeline replacement and rehabilitation
    - $197 million for trunk sewer rehabilitation
    - $82 million for treatment plants
    - $32 million for municipal sewer pump stations
    - $15 million for large sewer pump stations
    - $45 million for other projects, primarily the Metro Facilities Control System Upgrade, Wet Weather Storage Facility, and Annual Allocation - CIP Contingencies
- Meet ongoing O&M needs of the wastewater system, which includes mandates from the proposed Final Consent Decree
- Meet CIP pay-go costs of approximately 20% of the $648 million CIP program

The rate case evaluates the financial needs and accounts for all costs related to the system. The current rate case is intended to provide the first four years of necessary rate increases for the capital and operation and maintenance (O&M) program that is planned. Additional rate increases will be necessary to continue the program after that point in order to sustain compliance with the proposed Final Consent Decree. However, monies saved from ongoing department-wide Business Process Re-engineering (BPR) and Bid to Goal or Managed Competition will be applied to minimize future rate increases. The following is an overview of the Rate Case analysis and the Cost of Service Study performed to determine the necessary rates and assure apportionment of the rates in a fair and equitable manner.

**Rate Case**

To provide for the continued operation of the City's regional wastewater system on a sound financial basis, the revenues must be sufficient to meet the funding requirements or cash obligations of the system. Revenue requirements include O&M and CIP expenditures, principal and interest payments on existing debt and other obligations. The wastewater enterprise's annual expenditures are divided between: the Muni expenditures and the Metro expenditures. Muni relates essentially to the collection system in the City's own retail service area and Metro relates to treatment and disposal services shared both by the City and the Participating Agencies (PA).

The MWWD Services and Contracts Division annually receive O&M and capital expenditure information for both the Metro and Muni infrastructure components. The Division utilizes these costs to develop comprehensive O&M and CIP cost projections for the entire wastewater enterprise as part of its financing plan development.

The information regarding the financing plan is used to determine the overall revenue needs of the wastewater system, which is then used to determine the rate increases necessary to carry out the financial plan. In February, 2006, the City of San Diego entered into a consultant services agreement with Berryman & Henigar, Inc. to develop a current sewer rate case for MWWD based on the financing plan developed by MWWD. In addition, the financing plan was reviewed by the Public Utilities Advisory Commission (PUAC) wastewater rate sub-committee, the accounting firm Mayer Hoffman McCann, P.C., and Raftelis Financial Consultants, Inc. for the cost of service study. After several meetings and document review, the PUAC subcommittee recommended supporting the proposed rate increases and the full PUAC voted to unanimously support the proposed rates. The accounting firm of Mayer Hoffman McCann, P.C. provided an agreed-upon procedures review and also indicated that the rates were reasonably supported (see attachments). Finally, the proposed rate increases are required to allow the City to sign the proposed Final Consent Decree with the EPA by June 30, 2007. These proposed rates will fund the O&M and CIP projects mandated in the first four years of the Final Consent Decree.

*[This proposal does not include potential costs of providing secondary treatment at the Point Loma Wastewater Treatment Plant, as a decision has not been reached regarding implementation of this project.]*

The fiscal year 2007 through 2010 financing plan for MWWD is shown in the schedule below:

**METROPOLITAN WASTEWATER DEPARTMENT**
**FY2007 - FY2010 FINANCING PLAN**
(Escalated Dollars in Thousands)

| DESCRIPTION | FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|---|
| **OPENING BALANCES** | | | | |
| Balance from Prior Year | 52,162 | 15,777 | 32,468 | 28,984 |
| Prior Year Encumbrances & Cont. Appropriations | 30,687 | 65,016 | 44,219 | 54,474 |
| **REVENUES** | | | | |
| Bond Proceeds | 199,388 | 80,270 | 95,590 | 148,380 |
| Service Charge Revenues | 233,378 | 257,020 | 288,335 | 313,608 |
| Sewage Treatment Plant Services | 70,376 | 73,917 | 77,619 | 81,144 |
| Interest Earnings | 3,923 | 4,725 | 5,222 | 6,207 |
| Services Rendered to Others | 7,189 | 7,476 | 7,775 | 8,086 |
| Capacity Charge | 14,984 | 15,139 | 15,294 | 15,450 |
| Other Revenues | 24,953 | 3,518 | 3,518 | 3,518 |
| **TOTAL OPENING BALANCES & REVENUE** | $ 637,040 | $ 522,858 | $ 570,940 | $ 659,751 |
| **EXPENDITURES*** | | | | |
| Debt Service | 95,947 | 99,251 | 105,750 | 113,481 |
| Repay 2004 Bonds | 152,000 | 0 | 0 | 0 |
| Capital Improvements: | | | | |
| Prior year appropriations | 30,687 | 65,016 | 44,219 | 54,474 |
| Current year appropriations & bond proceeds | 91,927 | 75,188 | 129,744 | 191,534 |
| Operating & Maintenance Expenses: | | | | |
| Administrative Services (Finance, IT, HR) | 63,137 | 64,269 | 66,929 | 70,049 |
| Engineering and Program Management | 12,142 | 12,359 | 12,871 | 13,471 |
| Wastewater Treatment | 87,420 | 88,988 | 92,672 | 96,990 |
| Wastewater Collection | 58,280 | 59,325 | 61,781 | 64,660 |
| Environmental Monitoring and Tech Services | 21,855 | 22,247 | 23,168 | 24,248 |
| | 242,834 | 247,189 | 257,421 | 269,418 |
| **TOTAL EXPENDITURES** | $ 613,395 | $ 486,644 | $ 537,134 | $ 628,907 |
| Operating Reserve Increase | 7,868 | 3,746 | 4,822 | 8,890 |
| Funds Available for Appropriations | 15,777 | 32,468 | 28,984 | 21,954 |
| **TOTAL BALANCE** | $ 23,645 | $ 36,214 | $ 33,806 | $ 30,844 |
| **TOTAL EXPENSE & BALANCE** | $ 637,040 | $ 522,858 | $ 570,940 | $ 659,751 |

* Includes projected encumbrances

In addition, the following Wastewater Rate Model Assumptions were made:

**Consent Decree:** The Consent Decree projects are set to the following schedule for rehabilitation and replacement of collection system pipelines: In fiscal year (FY) 2008 - 30 miles of rehabilitation; FY2009 - 35 miles of rehabilitation and 10 miles of replacement of pipelines; FY2010 through 2013 – 25 miles of rehabilitation and 20 miles of replacement and FY2014 through FY2017 – 15 miles of rehabilitation and 10 miles of replacement. The estimated cost is $2.3 million per mile for pipe replacement and $800 thousand per mile for pipe rehabilitation.

**Financing:** Private bond financing is scheduled for April 2007. The estimated bond proceeds are less than $200 million including funding the bond redemption of $144.6 million. Public bond financing is scheduled for April 2008. The public bond proceeds are estimate at less than $90 million. Interest rate estimated for the projected private and public financing of 6% is based on the financial advisors' estimates. For interest rates we are assuming a level rate throughout the projected years.
Bond proceeds are calculated based on the estimated eligible capital improvements planned each year. In the early fiscal years of 2006-07 and 2007-08 a project by project analysis resulted in higher percentages (82.2% and 83.6%) of the capital expenditures than will be financed in those years. With the exception of the fiscal years of 2007 and 2008 it is assumed that 80% of the capital expenditures will be financed through the fiscal year 2014 and 70% of all capital expenditures for the remainder of the planning period will be financed.

**State Revolving Fund:** Repayment of loan proceeds begins one year after the project completion. The term of the loan is 20 years and the interest rate is 2% on the funds received. Source: SRF Loan Agreement.

**Debt Coverage Ratio:** The debt service requirements as covenanted in each Installment Purchase Agreement and State Revolving Fund (subordinate debt) are tested each projected fiscal year to assure compliance according to the agreement(s) terms.

**Financial Results:** FY 2003, 2004, 2005 & 2006 financial results are based on the best available financial data in November 2006 from the Auditor's office.

**Flow & Load Projections:** Agreed upon flows are based on sewage flow projections provided by Participating Agencies and MWWD in March 2006. The Flow data excludes Tijuana flow.
Flow, TSS and COD projections based on continuing evaluation of metered flow data, associated strength characteristics, current growth forecasts for specific sub-areas as well as wastewater monitoring reports from the mid-1980s to present. This is reported in the Metropolitan Sewerage System FY 06 Projected Flow and Strength Report (Draft) dated March 30, 2006.
For facility planning purposes, system-generated total suspended solids (TSS) concentration will remain at 197.7 metric ton/day for the 10-year planning horizon. The annual averaged TSS concentration for FY 2005 is 195 metric ton/day. The COD concentration will remain at 386.5 mt/d. The annual averaged COD concentration for FY 2005 is 382 mt/d. This is reported in the Metropolitan Sewerage System FY 06 Projected Flow and Strength Report (Draft) dated March 30, 2006.
For facility planning purposes, system-generated total suspended solids (TSS) concentration will remain at 293 mg/L for the 10-year planning horizon. The annual averaged TSS concentration for FY 2005 is 286 mg/L.

**Population Growth Projections:** City of San Diego and overall regional growth projections are generally based on San Diego Association of Governments (SANDAG) 2030 Forecasts which were approved by the Board of SANDAG in November 2003. The City and individual Participating Agencies provide annual detailed growth projections based on agency planning and historical growth.
For facility planning purposes, system-generated total suspended solids (TSS) concentration will remain at 197.7 metric ton/day for the 10-year planning horizon. The annual averaged TSS concentration for FY 2005 is 195 metric ton/day. The COD concentration will remain at 386.5 mt/d. The annual averaged COD concentration for FY 2005 is 382 mt/d. This is reported in the Metropolitan Sewerage System FY 06 Projected Flow and Strength Report (Draft) dated March 30, 2006.
For facility planning purposes, system-generated total suspended solids (TSS) concentration will remain at 293 mg/L for the 10-year planning horizon. The annual averaged TSS concentration for FY 2005 is 286 mg/L.

**Customer Accounts**: The projected customer accounts are based on projected years' rate of increase in the City of San Diego population. Source: The projected population is from the SANDAG 2030 population projections adjusted based recent historical growth. Current accounts were from the Water Utilities Customers Information System Monthly Rate Code Summary (Actual).

**Planning:** The initial rate increase is effective May 1, 2007 and any subsequent years' increases are projected on the same date. Rate increases are projected each year in this Rate Case sensitivity from 2007 through 2017. An initial goal is approved rates for four consecutive year period, with projected rates from fiscal year 2007 to fiscal year 2017.

**Right-of-Way Fees:** No Right of Way fees will be included.

**Shames Lawsuit:** The Shames Lawsuit is not considered nor a part of the cost data for the base case.

**Inflation**: Annual inflation for Services Rendered to Others (less than 2% of total revenue) and operations and maintenance costs is 4% based on the most recent 15 year San Diego area consumer price index for all urban consumers. The annual inflation for the construction component of capital projects is stated as a conservative 4% based on the Engineering News Record Construction Cost Index most recent 10 year annual average and 15 year annual average.

**Participating Agencies' Allocation:** The allocation of operations and maintenance cost and capital improvement program cost to the Participating Agencies is based on the PA's percentages of the annual flow and load through the Metropolitan Sewer System dated April 2006. Participating Agencies will continue to finance Metro system capital contributions as set forth in the Regional Wastewater Disposal Agreement (RWDA). This is approximately 30% of the cost.

**Participating Agencies' Contract Capacity:** The Participating Agencies own a contracted capacity of the Metropolitan Wastewater System. Two Participating Agencies are projecting a flow in excess of their contract capacity through Fiscal Year 2020. All other Participating Agencies and the City of San Diego are projecting having excess capacity and may sell capacity to the those with higher flow than existing capacity. There is adequate projected excess capacity among the Participating Agencies to accommodate those with future capacity needs. Therefore no revenue is projected from the sale of capacity by the City to Participating Agencies.

**Pension and Retiree Health Care Benefits:** And additional pension contribution is recognized at a cost of $1.9 million per year starting in year 2008 and continuing at the same value with inflation. Retiree health care benefits estimated liabilities will be considered and recorded as expenditures in the amount of $2.7 million beginning in fiscal year 2008 and increased to $8.3 million in year 2010 based upon the current best estimates.

**Secondary Treatment**: Secondary treatment at the South Bay Facility is planned for service by fiscal year 2018. Treatment at the secondary level at the Point Loma Wastewater Treatment Plant is not considered at all in the rate model.

**Fund Balance Interest**: Interest rates estimated for projected earnings on fund balance are based on the City Treasury Investments assumed return for fiscal year 2007 which is 3%. This rate is based on the most recent three plus years' data. For interest rates we are assuming a level rate throughout the projected years.

**Revenue**: The charges for the years 2007 through 2017 are based on the projected population and the projected service rates. The new connections are projected by the percentage change in population.

Capacity Charges are based on the 2006 Cost of Services Study throughout the ten year period from FY 2007 to FY2017. Treatment Plant Services are based on projected flow plus projected costs of treatment for the Participating Agencies (inflated).

**Minimum Fund Balance**: The minimum fund balance will be maintained at a minimum of $20 million of unrestricted funds.

**Rate Stabilization Fund**: The rate stabilization fund is established to stabilize the sewer service rates in future years.

**Operating Reserve**: The operating reserve is increasing from 45 days to 70 days starting in fiscal year 2007 to fiscal Year 2010.

**Unallocated Reserve:** This reserve is for contingencies and it is established in the operating budget each fiscal year at $3.3 million.

**Shames Lawsuit**

In 2004, a lawsuit was filed against the City by consumer advocate Michael Shames (Superior Court Case No. GIC 831539). The lawsuit alleges that SFR customers paid a disproportionately higher share of sewer rates, which benefited the commercial and industrial users. On December 6, 2006, City Council approved a settlement of the suit that would give rebates to approximately 225,000 single-family ratepayers.

The following is an overview of the Shames Settlement:

- Proposed settlement is subject to Court approval
- $40 million total to be returned to the SFR class, less $5 million in Plaintiff's attorneys fees, rebated over a 4 year period
- Most SFR customers to benefit
- SFR settlement class is based on residence from May 23, 1994, through September 30, 2004

The overall sewer rate increases with the proposed Shames settlement in Fiscal Years 2007 through 2010, will be as identified in the table below if the CIP and O&M rates are adopted. The Shames settlement rate impact in the first year will be 3.05% if the other proposed rates are adopted, or as high as 6.0% if no rate increase is adopted.

The following table shows the impacts of the Shames settlement if the proposed rates are adopted:

| Effective Date | May 1, 2007 | May 1, 2008 | May 1, 2009 | May 1, 2010 |
|---|---|---|---|---|
| CIP / O&M rates | 8.75% | 8.75% | 7.00% | 7.00% |
| Shames Settlement | 3.05% | 3.05% | 0.60% | 0.50% |
| Overall rates | 11.80% | 11.80% | 7.60 % | 7.50% |

The proposed rate increases of 8.75% on May 1, 2007, and May 1, 2008, and 7.00% on May 1, 2009 and May 1, 2010 will cumulatively provide approximately $241 million in additional revenue during those years.

**Cost of Service Study**

The rate case that was developed by Berryman & Henigar, Inc. determined the overall revenue needs to be derived from the rate payers. In conjunction with the development of the current sewer rate case, a utility cost of service and rate design study was conducted by Raftelis Financial Consultants, Inc. (RFC) (see Attachment). The COSS includes a thorough review of revenue requirements, cost of service allocations,

and design of a system of user charges for the City's wastewater service consistent with State Water Resources Control Board (SWRCB) Revenue Guidelines and City policies. The focus of the COSS was on the City's retail wastewater service which provided an overall basis for the apportionment of the rate increases between the various rate payer classes. The proposed rates are based on both the Berryman & Henigar rate case and the RFC Study. The specific objectives of the Study included:

- Update flow, Chemical Oxygen Demand (COD) and suspended solids loadings for all customer classes
- Update and review of wastewater revenue requirements
- Review and update of the allocation of treatment and collection costs to the wastewater parameters of Flow, Total Suspended Solids (TSS), and COD to retail customer classes
- Development of an appropriate SFR class sewer cap, and "return" to sewer factor in keeping with SWRCB guidelines
- Review of the fixed base charge component
- Update of full cost recovery capacity fees

The following major factors were considered as part of the Study:

*User Classification and Loading*

The City currently serves a population of nearly 1.2 million within the City's service area. In July, 2006 it was estimated that the City had a total of 270,805 meters. The breakdown of the City's sewer user classes, and the number of meters associated with each class as of FY 2006, are as follows:

| User Class Description | Number of Meters | Average Daily Flow |
|---|---|---|
| Single Family Residential (SFR) | 223,996 | 46.45 MGD * |
| Multi-Family Residential (MFR) | 30,395 | 34.06 MGD |
| Commercial/Industrial | 16,414 | 30.44 MGD |

- *MGD (Million Gallons Per Day)*

Residential users are similar in their flow strength characteristics and are, therefore, assumed to have identical TSS and COD loadings. The commercial/industrial user class varies widely based on the type of work in which they engage. A more detailed discussion of User Classifications and Loadings is contained in Section 4 of the Study (Attachment).

*Revenue and Expenses*

Revenue requirements from rates are the net of all expenditures, including reserve requirements, less non-rate revenues. The City's principal sources of revenue to recover operating costs include sewer service charges paid by the City's retail users and full cost recovery from the PAs per their cost sharing agreements with the City. The primary sources of revenue to recover capital costs include sewer connection fees, capital fund balance, bond proceeds, state and federal grants and loans, capacity fees, pay-as-you-go revenues from the PAs and interest earnings.

The City's retail service area O&M expenditures, which are the focus of this Study, are estimated to be in the range of $206 to $231 million per year between FY 2007 and FY 2011. Retail service area annual capital expenditures, including debt service and pay-as-you-go capital, are in the range of $81 to $137 million per year. Debt service constitutes the majority of capital expenditures and ranges between $72 and $102 million per year over that same time period.

*Rate Design*

The City's existing retail wastewater rate structure for SFR, MFR, and Commercial/Industrial user classes includes a fixed Base Fee and a Usage Rate. The Base Fee of $11.32 per month is the same for all customer classes. The base fee currently recovers approximately 16 percent of the overall revenue requirements of the City's wastewater enterprise. The current Usage Rate is applied differently according to customer class:

- SFR usage is based on 100 percent return of minimum winter water usage ("return") and is capped at 14 hundred cubic feet (HCF) monthly. Users are billed at a rate of $2.889 per HCF ;
- MFR usage is based on 95 percent return of water usage and billed at a rate of $3.721 per HCF; and
- Commercial/Industrial usage is based on a sewer return rate, the percentage of metered potable water returned to the sewer, and pollutant loadings developed for each business type according to Standard Industrial Classification (SIC) codes.

Both MFR and Commercial/Industrial class customers may have individual return rates and pollutant loadings based on monitoring performed on their wastewater discharges by the City.

*Study Recommendations*

SINGLE FAMILY RESIDENTIAL SEWER CAP

RFC recommends the SFR sewer cap be increased to 20 HCF and the assumed SFR return factor be dropped from 100 percent to 95 percent. SFR customers are currently subject to a 14 HCF sewer cap based on a mass balance analysis of customer winter usage. The purpose of the sewer cap is to determine the level at which it is assumed water usage ceases to be returned to the system as wastewater. Usage above the sewer cap is assumed to be outdoor usage for purposes such as irrigation and other outdoor uses. The prior cost of service study looked at this question and suggested that the sewer cap be raised to its current level of 14 HCF, then to 16 HCF two years later. Guidance from SWRCB personnel suggests that the sewer cap be set at a level that captures 95 percent of the SFR accounts. Using this SWRCB direction, the calculated sewer cap would fluctuate between 17 and 21 HCF, depending on climate conditions during the winter measurement months. In order to conform to SWRCB direction and in order to set a stable cap, the City has chosen to average five years of winter usage and establish 20 HCF as the proposed SFR sewer cap.

RATE DESIGN CHANGES

RFC recommends the continued use of a rate structure that includes both a fixed monthly base fee and a variable usage charge.

Base Fee: RFC recommends that the City continue to utilize a uniform monthly base fee for all system users. The current method for setting the base fee is appropriate under SWRCB guidance and the City may continue its use.

Residential Usage Rate: RFC recommends that the City continue its existing method of computing monthly SFR wastewater charges, but with a usage cap of 20 HCF instead of the existing 14 HCF cap as discussed above. RFC also recommends revising the SFR return factor to 95 percent from the current 100 percent.

Commercial/Industrial Usage Rate: For commercial/industrial users, RFC recommends that the City continue to charge users based on their flow and strength. The strength and return factors for these users are based on industry standards and built into the City's database. RFC also recommends that wastewater charges for Commercial/Industrial users discharging greater than 25,000 gpd of flow continue to be calculated individually based on measured or estimated strength.

Contract customers and hauled waste customers would continue to be charged on a unit cost rate in which the base fee is included in the unit rate for flow.

CAPACITY CHARGE

Capacity fees are one-time fees used to recover the cost of providing the system capacity required when a new user connects to the wastewater system. Examples of such costs include those related to increasing wastewater transmission and treatment capacity in treatment plants, ocean outfalls, interceptors, pumping stations, and sewer mains.

The City currently charges $3,710 per equivalent dwelling unit (EDU) or SFR account. The minimum capacity assigned to any sewer connection is one EDU. Qualifying low income housing is eligible for a reduced capacity fee as outlined in Water Department Instruction 55.30. MFR units having individual, City-read water meters are assigned one EDU per unit, while MFR units that share a common water meter are charged based on a density-adjusted formula. Non-residential customers are charged based upon the number of fixture units by using a conversion factor that equates 20 fixture units to one EDU.

The City has incurred major costs over the last ten years to upgrade and expand facilities and will continue to incur additional costs to comply with EPA mandates to meet discharge requirements. The capital costs of existing facilities and growth-related portion of future costs of improvements to the City's facilities form the basis of the calculated capacity fee. The capital costs the City has incurred prior to 2006 and the future costs to be incurred over the next ten years were reviewed. The projects associated with these capital costs were examined and the net capacity available from these projects was determined in order to derive the capacity fee. These projects include sewer mains, pumping stations, treatment plant upgrades, outfall costs etc. The resultant full-cost-recovery capacity fee is $4,124 per EDU.

The COSS recommendations are consistent with and are reflected in the Wastewater rate case. The City Council's ability to deviate from these rates is limited: the rate adjustments proposed by this report can only be changed if the alterations are consistent with the COSS. Changes that are inconsistent with the COSS could violate the requirement of Proposition 218 that wastewater fees not exceed the proportionate cost of providing the service to each parcel. Therefore, any proposed changes should be examined carefully.

BASE CHARGE

Under SWRCB guidance, RFC believes the existing methodology for determination of the base fee is appropriate. For these reasons, the City has decided to continue with its existing methodology for development of the customer base charge.

**Mayor's Pre-conditions**

As a requirement prior to considering any new rate recommendations, the Mayor's Office set stringent pre-conditions for MWWD and the Water Department to address. Mayor Sanders directed City staff to undertake review efforts in response to concerns about potential mismanagement and inefficiencies in both systems. The Mayor's pre-conditions included:

- Completion of a comprehensive examination of the budgets and rate structures of both the water and wastewater systems
- A review by outside accountants of past practices regarding the use of previous rate increases and bond proceeds by both systems
- A detailed report regarding whether the water or wastewater systems had raised rates for projects that have not been, or never will be, completed
- An analysis of the various operational and capital demands on the systems' cash flows
- A complete accounting of any funds that have been transferred out of these systems and for what purposes
- A study of how San Diego's water and wastewater rates compare with surrounding agencies
- A thorough report of what administrative expenses can be trimmed from both systems

In addition to the outlined pre-conditions, the Mayor has stated that additional safeguards will be put in place to ensure that funds derived from rate payers are spent appropriately.

**Results of Mayor's Pre-conditions**

The City entered into agreements with the audit firm of Mayer Hoffman McCann P.C. (MHM) to perform a review of how bond proceeds and previous rate increases were used and a review of the proposed rate increases in the Metropolitan Wastewater Department. MHM offered the findings of those reviews in a series of reports delivered to the Mayor in August 2006. The results of the MHM reviews found that MWWD appropriately spent bond proceeds and revenue from previous rate increases and followed appropriate accounting standards. The MHM reports did note that a very few inter-fund transfers from the wastewater enterprise accounts were made "inappropriately." At the Mayor's direction, the transfers noted by MHM have been reimbursed to the wastewater fund. The Mayor adopted all of the remedial recommendations contained in the reports regarding bond proceeds and previous rate increases.

**Efficiency Efforts**

MWWD is currently going through a Bid-To-Goal analysis and Business Process Re-engineering, and anticipates having final results by the end of this calendar year. The preliminary results and recommendations of these efforts were considered in determining the proposed sewer rates. These efforts have resulted in recommendations that would generate salary and fringe savings of approximately 13% and a proposed reduction in staff of approximately 140 full time equivalent positions in FY2008.

In addition, MWWD has been proactive in assessing its business processes over the past years. The following programs have resulted in savings over the years due to MWWD's practice of continuous process improvements:

- Bid to Goal (1998-2005) has resulted in approximately a $120 million budget reduction and $70 million in additional savings
- Cost Savings Initiatives – Value Engineering, Business Case Evaluation, Zero-Based Management Review
- Proactive in Energy Savings and Management – MWWD owns or controls on site power generation (these facilities include cogeneration of digester gas and landfill gas, hydroelectric and photovoltaic systems) which provides approximately $5 million/year savings and $1.0 million/year in revenue. MWWD has also conducted energy audits and obtained approximately $1.5 million in energy grants and incentives since 2001

- International Standards Organization (ISO 14,001) certified in three Divisions (O&M, Wastewater Collection, and Environmental Monitoring & Technical Services)

**Recommendations**

In order to meet projected revenue requirements, including desired operating and debt service reserve fund levels, the following annual revenue adjustments are recommended by the Study:

| FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|
| 8.75% | 8.75% | 7.00% | 7.00% |

The current and proposed rates for each sewer classification are described below:

| Class | Current Base | Current Rate/HCF* | Proposed Base | Proposed Rate/HCF* | % Change |
|---|---|---|---|---|---|
| Single Family Residential | $11.32 | $2.889 | $12.31 | $2.890 | 8.7% |
| Multi-family Residential | $11.32 | $3.721 | $12.31 | $4.038 | 8.5% |
| Commercial/Industrial | | | | | |
| Base | $11.32 | | $12.31 | | 8.7% |
| Flow | | $2.753 | | $3.026 | 9.9% |
| Total Suspended Solids | | $0.429 | | $0.443 | 3.2% |
| Chemical Oxygen Demand | | $0.154 | | $0.180 | 16.6% |
| Contracts: Navy & Hauled Waste | | | | | |
| Flow | | $2.753 | | $3.132 | 13.8% |
| Total Suspended Solids | | $0.429 | | $0.459 | 6.8% |
| Chemical Oxygen Demand | | $0.154 | | $0.186 | 20.7% |

* 1 HCF (Hundred Cubic Feet) = 748 Gallons

FISCAL CONSIDERATIONS:

Cost of noticing property owners and utility customers at this time is estimated at $230,000. This cost will be shared equally by MWWD and the Water Department.

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

The PUAC sewer rate subcommittee, at the meeting of November 29, 2006, supported the proposed sewer rate increases of 8.75% in Fiscal Years 2007 and 2008 and 7% in Fiscal Years 2009 and 2010 by a vote of 4 to 1 in favor of the action; and supported the Study recommendations by a vote of 4 to 1 in favor of the action.

At the meeting of December 4, 2006, the PUAC unanimously voted in favor of the proposed sewer rate increases of 8.75% in Fiscal Years 2007 and 2008 and 7% in Fiscal Years 2009 and 2010, and the COSS recommendations.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

Public Input sessions have been held throughout San Diego as follow:
Various stakeholder meetings
November 27, 2006 Town Hall Meeting San Ysidro Multi-Cultural Center
November 28, 2006 Town Hall Meeting Balboa Park War Memorial
November 29, 2006 PUAC Water and Wastewater Rate Sub-Committee Meeting
December 4, 2006 Full PUAC Meeting
December 5, 2006 Town Hall Meeting Rancho Bernardo Library
A stakeholder meeting will be scheduled the week of January 2, 2007
Additional public outreach and workshops will be scheduled before the public hearing date.
Additional community outreach briefings will be scheduled at the request of Council members and the Community.

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

City of San Diego wastewater users will receive a notice of the hearing to take palce on February 26, 2007.

Robert J. Ferrier
Acting Metropolitan Wastewater Department
Director

R.F. Haas
Deputy Chief of Public Works

Attachments:

1. Proposition 218 Notice
2. 4-year CIP Project Estimates
3. Raftelis Financial Consultants, Inc. Wastewater Cost of Service Study
4. Mayer Hoffman McCann P.C., Independent Accountant's Review (4 reports)
5. Sewer Rate Comparisons